United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

77-5004

To be Argued By
FREDERICK H. BLOCK

United States Court of Appeals

SECOND CIRCUIT

HOUSEHOLD FINANCE CORPORATION,
Plaintiff-Appellant,

—against—

KEITH ORIN DANNS, a/k/a KEITH O. DANNS,
a/k/a KEITH DANNS,
Defendant-Appellee.

APPELLANT'S BRIEF

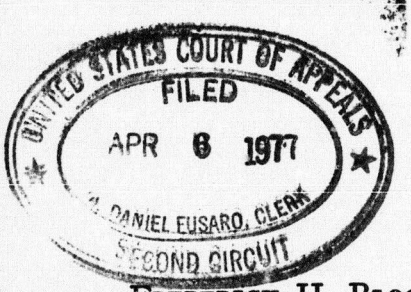

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TABLE OF CONTENTS

PAGE

QUESTION PRESENTED 1

STATEMENT OF THE CASE 1

1. Introductory 1
2. The Facts 2

POINT I—CONGRESS CLEARLY INTENDED TO BAR A DEBT INCURRED DISHONESTLY BY A BANKRUPT AND NOT MERELY A PART THEREOF 6

1. Introductory 6
2. The Statute, Its Legislative History and Construction Prior to 1970 6
3. The Post-1970 Interpretation of the Statute ... 15
   - A. Introductory 15
   - B. The Federal Cases 19

SUMMARY 24

CONCLUSION 25

ADDENDUM

Matter of Shade (W. D. N. Y. 1974) AD1

In Re Birkholz, 71 BK 517 (W. D. Wisc. 1972) ..AD5

H. F. C. v. *Clem,* B 75-397 (D. C. Ore. 1976) AD8

AUTHORITIES

CASES:

Advance Loan Co. vs. Bell (N. M. 1965) 402 P. 2d 944 14

Budget Fin. vs. Haner (Idaho 1968) 436 P. 2d 722 14

Federal Finance Company vs. Merkel (Wash. 1964) 397 P. 2d 436 .....11, 13

First Credit Corp. vs. Wellnitz (Wisc. 1963) 123 N. W. 2d 519 .....13, 20

PAGE

In Re Ellis 400 F. Supp. 1112 (S. D. N. Y. 1975) 15, 17, 20
In Re Fuhrman, 385 F. Supp. 1185 (W. D. N. Y. 1973) 22
In Re Schuerman 367 F. Supp. 1347 (E. D. Ky. 1973) 15, 20
H. F. C. vs. Clem B 75-397, 8 (D. C. Ore. 1976) .. 20
H. F. C. vs. DeShazo (Wash. 1961) 359 P. 2d 1044 8
H. F. C. vs. Walters (Ariz. 1968) 443 P. 2d 929 ..... 14, 16, 23
In Re Birkholz, 71 BK 517 (W. D. Wisc. 1972) .. 20
Liberal Finance Corp. vs. Holley (La. 1963) 157 So. 2d 376 13
In Re Soika, 365 F. Supp. 555 (W. D. N. Y. 1973) 22, 23
Local Indus. Fin. Co. vs. McDougale (Ky. 1966) 404 S. W. 2d 789 ..... 8, 14
Matter of Shade (W. D. N. Y. 1974) 19
Seaboard Fin. vs. Barnes (Mich. 1967) 148 N. W. 2d 756 14

STATUTES:

Bankruptcy Act, § 17(a)(2), 11 U. S. C. § 35(a)(2) 1, 6
Bankruptcy Act, § 14(c)(3), 11 U. S. C. § 32(c)(3) 7
N. Y. Banking Law § 352(b) 4
Pub. L. 86-621 8
Pub. L. 91-467 14

OTHER AUTHORITIES:

1 A Collier *on Bankruptcy* (14th ed.) 1261 19
Id p. 1578 14
Id p. 1580.1 15

PAGE

HR 32, 94th Cong. 18

HR 6, 95th Cong. § 523 18

House Report #1111, Sept. 1, 1959 9

House Report #91-1502 14

1958 Hearing on H. R. 106, Senate Sub-Comm. on the Judiciary, 85th Cong. 2d Sess. pp. 89, 102 .. 12

Senate Report #1688, June 24, 1960 11

Shuchman, *Fraud Exception in Consumer Bankruptcy,* 23 Stanford Law Review, 735, 766 (1971) 17

Id. fn. 25 at pp. 740-741 18

Shuchman, *Impact Analysis of the 1970 Bankruptcy Discharge Amendments,* 61 North Carolina Law Review 233, 239 (1972) 17

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APPELLANT'S BRIEF

QUESTION PRESENTED

Was the court below in error in interpreting Bankruptcy Act, Section 17(a)(2), 11 U. S. C. Sec. 35(a)(2) to mean that a dishonest debtor is entitled to a discharge from his entire debt, save only the "fresh cash", where the debtor, through a false financial statement, obtained a refinancing of an existing indebtedness?

The foregoing question has never been passed upon by this Court or any of the other federal courts of appeal and the district courts in this circuit are in conflict on the question.

STATEMENT OF THE CASE

1. Introductory

Household Finance Corporation (HFC) appeals from an order of Hon. Edward R. Neaher, United States District Judge for the Eastern District of New York, dated January 17th, 1977, which affirmed an order of Bankruptcy Judge C. Albert Parente. Judge Parente found that Danns, the bankrupt and the appellee here, had issued a financial statement to HFC in connection with the refi-

nancing of an existing loan, which was materially false in writing, was given with intent to deceive and was relied upon by the plaintiff. Judge Parente nevertheless denied HFC's application to have the debt, which then amounted to $2,189.31, declared non-dischargeable. Judge Parente held that a discharge was barred only as to the sum of $483, the "fresh cash" received by the bankrupt at the time of submitting the false financial statement.

HFC contends that the entire debt should have been held to be non-dischargeable.

2. The Facts

Danns filed his petition in bankruptcy on January 16, 1976, less than a year after he obtained a refinancing of his loan with HFC. The schedules reflect an essentially no-asset situation and the following substantial debts (in round numbers), all of which were owed as of the date of the refinancing of his loan with HFC (A 6-8)* and were not disclosed in the financial statement he submitted as hereinafter appears.

Creditor	Date of Obligation	Amount
Chemical Bank	4/22/74	$ 2,700
First National City Bank	6/74	1,400
R. H. Macy	7/74	1,100
Pan-Am	3/11/74 and 9/18/74	1,100
W. T. Grant	6 and 7/74	1,000
Beneficial Finance	6/5/74	1,300
Gertz	6/74	3,000
Ford Motor Credit Company ..	6/5/74	2,400
		$14,000

*References, unless otherwise indicated, are to pages of the Appendix.

After the filing of the petition, HFC commenced an action to bar the bankrupt's discharge as to his debt in the amount of $2,189.31 (A 13-14). The answer (A 15) denied the material allegations of the complaint.

At trial the bankrupt testified that on or about January 24, 1975, he requested a "renewal" of his loan with HFC (A 30) which, as shown on the financial statement he submitted at the time amounted to $2,019.37 (Ex. 2 at A 77).

On the financial statement, apart from his debt to HFC, Danns listed a debt to Gertz in the amount of $50 instead of the $3,000 shown on the schedule. He admitted in his testimony that he wrote the words "I have no other debts" on the financial statement (A 23). However at the time, as Danns admitted at the trial, he was indebted to Beneficial Finance for $1,000 (A 25) to Macy's in the sum of $1,000 (A 27), to First National City Bank in the sum of $3,000 to Ford Motor Credit Corporation in the sum of $3,100 for the purchase of a Mercury car, to Chemical Bank in the sum of $3,100 (A 28) and to W. T. Grant & Company in the sum of $933 (A31) for an aggregate of undisclosed debts exceeding $10,000. The bankrupt earned $250 per week (A 19).

Danns testified that he failed to list his debts on the financial statement because of the instructions he received from the representative of HFC who handled the matter. He claimed that the HFC representative did not ask him whether he had any other debts but merely instructed him to write the words "I have no other debts". He testified further that his signing of the financial statement represented an afterthought on the part of HFC only after he had received the check in the transaction (A 37-38, A 42).

Tillinghast, the manager of the HFC branch at which Danns dealt, contradicted Danns' statement that the check had been given to Danns before Danns had filled in and signed the financial statement. Tillinghast said that he was

the one who signed the check and that he only approved the loan and signed the check after he had reviewed the financial statement (A 52-53). Tillinghast went on to say that he relied on the financial statement in approving the loan and that he would not have extended credit to Danns if he had known of the undisclosed debts (A 45-46).

Ament, another employee of HFC at the branch in question, testified that he handled the matter with Danns and witnessed the signing of the financial statement (A 56). He squarely contradicted Danns' testimony by saying that he had inquired of Danns in connection with the financial statement whether he had any other debts other than those to HFC and Gertz and that when he received an answer in the negative, he requested Danns to write "I have no other debts" on the financial statement (A 61). He testified further, in corroboration of Tillinghast's testimony, that the application for the loan and the financial statement were completed before the proposed loan was presented to Tillinghast for approval and that the check was issued after such approval (A 57, A 59).

Although the bankrupt had testified he sought a renewal of his loan to get additional needed money (A 30) and the Bankruptcy Judge characterized the new loan as a renewal without objection at the trial (A 48) it is not contended here that there was a renewal in the true sense involving a matured note. Cf. the opinion below (A 83). Under the thrust of New York Banking Law § 352(b) (which prohibits a small loan company from having more than one loan contract in effect at any one time)* the note

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*The statute reads:

"No licensee shall permit any loan to be split up or divided. No licensee shall induce or permit any person, nor shall any licensee induce any husband and wife jointly or severally, to become obligated, directly or contingently, or both, under more than one contract of loan at the same time, for the purpose or with the result of obtaining a higher rate of interest than would otherwise be permitted by this section."

for the old obligation of $2,019.37 (reflected on Ex. 2 at A 77) was cancelled and the new note replaced it (Ex. 1 at A 75). The fresh cash of $483 referred to by the Bankruptcy Judge (A 49) represented the difference between the amount of the old note and the amount of the new note, exclusive of finance charges.*

At the date of bankruptcy about a year after the refinancing, the debt as shown in HFC's complaint amounted to $2,189.31 (A 14).

At the conclusion of the testimony, HFC moved for judgment and the court ruled as follows, completely rejecting the bankrupt's version (A 71):

> "The Court having weighed the evidence, and having examined into the credibility of the witnesses' testimony, finds that the plaintiff has sustained its burden of proof showing that the financial statement was materially false in writing, and was given with the intent to deceive, and that it was relied upon by the plaintiff.
>
> Judgment is awarded in the sum of the fresh cash received by the Bankrupt at that time, to wit, the sum of $483.00 with appropriate interest thereon."

On appeal to the District Court, there was no challenge to Judge Parente's findings as to the financial statement and his rejection of the bankrupt's version. The only question on appeal was the question of law presented by the refusal of the Bankruptcy Judge to extend non-dischargeability to the amount of the entire indebtedness.

In affirming Judge Parente's holding that the bar to discharge applied only to the fresh cash, Judge Neaher in his opinion and order (A 81) relied on cases which mis-

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*It is hereinafter contended, that the transaction represented a refinancing within § 17(a)(2).

construed the intent of Congress in enacting the pertinent 1960 and 1970 amendments to the Bankruptcy Act.

POINT I

CONGRESS CLEARLY INTENDED TO BAR A DEBT INCURRED DISHONESTLY BY A BANKRUPT AND NOT MERELY A PART THEREOF.

1. Introductory

As noted, the question presented for review has not been passed upon by this or any other circuit. That is not to say, however, that the question here presented is new. Other bankrupts confronted with their proven fraud tried for years to convince the state courts which then had jurisdiction of the dischargeability issue, that a discharge should be barred only as to fresh cash. The highest courts in all of the states that considered the matter eventually rejected the contention.

As we shall show, the development of the Bankruptcy Act, the clearly expressed Congressional intent and the express words of the statute do not support the decision below.

2. The Statute, Its Legislative History and Construction prior to 1970.

The statute here involved is Bankruptcy Act, § 17(a)(2) which reads as follows in pertinent part:

> "Debts not affected by discharge
>
> (a) A discharge in bankruptcy shall release a bankrupt from all of his provable debts whether allowable in full or in part except such as * * *
>
> (2) are liabilities for obtaining money or property by false pretenses or false represen-

> tations, or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made or published or caused to be made or published in any manner whatsoever with intent to deceive * * *"

Prior to 1960 entitlement to a discharge was provided for by § 14(c) which read in pertinent part as follows:

> "(c) The court shall grant the discharge unless satisfied that the bankrupt has . . . (3) obtained money or property on credit, or obtained an extension or renewal of credit by making or publishing or causing to be made or published in any manner whatsoever, a materially false statement in writing respecting his financial condition."

As a result of the 1938 Chandler Act, § 17 which made certain debts non-dischargeable, read as follows up until 1960 in pertinent part:

> "A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as * * * (2) are liabilities for obtaining money or property by false pretenses or false representations * * *."

Between 1938 and 1960 creditors in light of the foregoing had a choice of proceeding under § 14c or § 17(2) where a false statement was involved. Under the provisions of § 14(c) establishment of a false statement had the harsh result of barring a bankrupt's discharge as to all his debts whereas under 17(2) only the liability for obtaining money or property by false pretenses or false representations was non-dischargeable.

The fresh cash approach had its origin when lenders who were reluctant to proceed under § 14(c) claimed that a discharge should be barred under § 17(2) on the ground that the false financial statement constituted a false representation under that statute. The reluctance was based on the unwillingness of a lender to provide a windfall for other creditors unaffected by the false statement.

While a majority of the state courts had no problem in holding that the new note was non-dischargeable (see cases collected in *Local Industrial Fin. Co.* v. *McDougale,* (Ky. 1966) 404 S. W. 2d 789, a minority refused to so hold on the ground that the debtor in refinancing his old obligation did not obtain money or property. See, e.g., *HFC* v. *DeShazo,* (Wash. 1961) 359 P. 2d 1044. Accordingly those courts held that non-dischargeability was limited to the money received in the refinancing, i.e., the fresh cash.

The Celler Amendment (Pub. L. 86-621) was enacted in 1960 and changed the law drastically as to a non-business bankrupt. The giving of a false financial statement was no longer to bar a discharge as to all his debts for a non-business bankrupt. This was accomplished by transferring from § 14(c) to § 17(a)(2) the language which now appears in the statute. After the Celler Amendment, the pertinent part of the statute read as follows with the new matter in italics:

> "(a) A discharge in bankruptcy shall release a bankrupt from all his provable debts, whether allowable in full or in part, except such as * * * (2) are liabilities for obtaining money or property by false pretenses or false representations, *or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financal condition made or published or caused*

to be made or published in any manner whatsoever with intent to deceive."

The House report No. 1111 (U. S. Code, Congressional and Administrative News, 86th Cong. 1960, Vol. 2, pp. 2955-6) explained the legislation:

> "The committee believes that complete denial of a discharge is too severe a penalty in the case of the individual noncommercial bankrupt. It is also a penalty which experience has shown to be subject to abuse. An unscrupulous lender armed with a false financial statement has a powerful weapon with which to intimidate a debtor into entering into an agreement in which the creditor agrees not to oppose the discharge in return for the debtor's agreement to pay the debt in full after discharge. The creditor may also accomplish his purpose of preserving his debt by not opposing the discharge and then suing in a State court on the ground that the debt is not dischargeable. Testimony before the Subcommittee on Bankruptcy and Reorganization by experts in bankruptcy law indicates that unscrupulous lenders have frequently condoned, or even encouraged, the issuance of statements omitting debts with the deliberate intention of obtaining a false agreement for use in the event that the borrower subsequently goes into bankruptcy.
>
> Even where the creditor has had no part in the issuance of a false financial statement, the exercise of his right to bar the discharge completely results in a windfall for other creditors who were not even aware of such a statement. Debts which are dischargeable are not discharged solely because one of many debts was induced by a false financial statement. This result is not required to protect a credi-

tor who has relied on a false financial statement since under section 17a(2) that particular debt is not dischargeable.

In view of the protection which section 17a(2) gives to the creditor, and in view of the abuses which have grown out of section 14c(3), the committee believes that it is desirable to eliminate the false financial statement as a ground for the complete denial of a discharge insofar as the individual noncommercial bankrupt is concerned.

The bill also amends section 17 of the Bankruptcy Act, entitled, "Debts Not Affected by a Discharge", by adding in a(2) the following new language—

> or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made or published or caused to be made or published in any manner whatsoever with intent to deceive.

The Committee on the Judiciary of the House of Representatives in its report on the bill has commented in regard to this addition—

> The purpose of this amendment is to assure that although the obtaining of money or property on credit through the issuance of a false financial statement is no longer to be ground for denial of a discharge to a nonbusiness bankrupt, any obligation incurred as a result of such a statement to be nondischargeable under section 17. The addition of the elements of reliance by the creditor and intent to deceive by the debtor are merely enactments of existing case law."

Senate Report 1688 (U.S. Code, Cong. & Adm. News, 86th Cong. 1st Sess. (1960) p. 2954) said that the purpose of the bill "is to limit the use of false financial statements as a bar to discharge in bankruptcy" and adopted the House Report.

The adoption of the amendment was regarded as a compromise whereby in exchange for removing the power of small loan companies to block a bankrupt's discharge from all of his debts under § 14(c), Congress gave the small loan companies the right to secure their whole indebtedness from a dishonest debtor if the requirements of 17(a)(2) are satisfied. *Federal Fin. Co.* v. *Merkel* (Wash. 1964) 397 P. 2d 436.

This view is borne out by the following exchange between Landon Chapman, a lawyer who specialized in representing wage-earners who filed voluntary bankruptcy petitions, and Senator Ervin:

> "MR. CHAPMAN. * * * There has been a proposed amendment to § 17(a) here which adds in somewhat, I think, mere surplusage, and there is a little advantage stuck in there because the prevailing cases have held recently, I think, that where a debtor had borrowed money and, say, owed a loan company $400 and he goes in and borrows another hundred, when he borrows the second hundred he gives the false financial statement.
>
> He gets the last hundred, the loan company adds all his indebtedness together, making a $500 loan, adding the old debt authough the loan company loses only a hundred.
>
> SENATOR ERVIN. They are making a further extension of credit?

MR. CHAPMAN. Getting an extension of credit on the old debt. Now the man may go bankrupt a month later.

The loan companies in the courts have been suing for the whole $500. Some of the courts have held that the loan company is entitled only to the $100 and whatever damages it has suffered by extending credit on the other $400.

If you put in this extension of credit here, you get a reverse opinion on that.

Some of the courts have already held the other way. They hold that he must pay the full $500. I think the prevailing view is that he has only to pay the damages they suffered.

I think that is the best law. I think when a man has committed a wrong he should pay for that wrong but no more, and I think that this amended part of section 17 should be left out.

But as I said in the beginning, if the whole thing is taken together had (sic) has to go, it is whole hog or none, I will take it as is. I think it is an improvement; I think its good parts overbalance the bad very much." (1958 Hearing on H.R. 106, Senate Sub-Comm. on the Judiciary, 85th Cong. 2d Sess. pp. 89, 102).

The Celler Amendment dramatically laid the fresh cash issue to rest. The courts of Washington, Wisconsin and Louisiana which had held to the minority view on fresh cash because of the money or property problem under former § 17 reversed themselves and held that it was the clear intent of Congress in enacting the Celler Amendment to make the entire indebtedness non-dischargeable. *Federal*

Finance Company v. *Merkel* (Wash. 1964) 397 P. 2d 436; *First Credit Corp.* v. *Wellnitz* (Wisc. 1963) 123 N. W. 2d 519; and *Liberal Finance Corp.* v. *Holley* (La. 1963) 157 So. 2d 376.

In *Merkel, supra,* the highest court in the State of Washington explained why it was required to overrule its previous decision in DeShazo:

> "We have given this case extensive treatment because we have concluded that the above amendments have changed the statutory underpinnings of the DeShazo decision. We have been hesitant to depart from DeShazo because that case followed a policy which minimized the amount of debts that continue to drag on a debtor after a bankruptcy discharge.
>
> This, of course, is basic to the underlying policy of the National Bankruptcy Act. However, it now appears that Congress has shifted its emphasis in this area. In exchange for removing the power of small loan companies to block discharge, Congress has given the small loan companies the right to secure their whole indebtedness from a dishonest debtor if the requirements of § 17, sub. a(2) are satisfied. Since we are convinced that congressional intent is clear in this case, we cannot substitute our judgment for the obvious policy decision that Congress has made here. Thus, we conclude that the amendments to § 14, sub. c(3) and § 17 sub. a(2) make the DeShazo opinion inoperative."

A leading text writer reached the same conclusion as to the effect of the amendment:

> "With the amendment of § 14c(3) removing the false financial statement as a ground for objecting to the discharge in bankruptcy of the nonbusiness

bankrupt it became important to make certain that the obtaining of money, property or credit by use of such false statement resulted in a nondischargeable debt. Although case law had reached this conclusion prior to the amendment, the addition of the following clause in § 17(2) removed any doubt on the subject:

> "or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made or published or caused to be made or published in any manner whatsoever with intent to deceive . . ." (footnotes omitted). 1 A Collier *on Bankruptcy* (14th ed.) 1578.

Thus prior to 1970 and after the enactment of the Celler Amendment, the highest courts of all the states which had passed on the fresh money issue held, without a dissent, that it was the intent of Congress to bar a discharge as to the entire indebtedness incurred by a bankrupt as a result of a financial statement that was proved to be within the provisions of § 17(a)(2)*.

In 1970 the Bankruptcy Act was amended to provide that all questions of dischargeability were to be heard exclusively in the bankruptcy courts (Pub. L. 91-467). The House Report (91-5102) explains the legislation:

> "As stated in the report on this measure by the Senate Judiciary Committee, the major purpose of the proposed legislation is to effectuate more fully,

**HFC* v. *Walters* (Ariz. 1968) 443 P. 2d 929; *Local Indus. Fin. Co.* v. *McDougale* (Ky. 1966) 404 S. W. 2d 789; *Budget Fin.* v. *Haner* (Idaho 1968) 436 P. 2d 722; *Seaboard Fin.* v. *Barnes* (Mich. 1967), 148 N. W. 2d 756; *Advance Loan Co.* v. *Bell* (N. M. 1965), 402 P. 2d 944; and the courts of Louisiana, Wisconsin and Washington in the decisions *supra* at p. 13.

> the discharge in bankruptcy by rendering it less subject to abuse by harassing creditors. Under present law creditors are permitted to bring suit in State courts after a discharge in bankruptcy has been granted and many do so in the hope the debtor will not appear in that action, relying to his detriment upon the discharge. Often the debtor in fact does not appear because of such misplaced reliance, or an inability to retain an attorney due to lack of funds, or because he was not properly served. As a result a default judgment is taken against him and his wages or property may again be subjected to garnishment or levy. All this results because the discharge is an affirmative defense which, if not pleaded, is waived.
>
> S. 4247 is meant to correct this abuse." (1970 U. S. Code, Cong. & Adm. News, p. 4156).

No substantive change in 17(a)(2) was effected. 1A Collier *on Bankruptcy* (14th ed.) p. 1580.1.

Nevertheless, as we shall see, the lower federal courts mistook the grant of jurisdiction provided by the 1970 amendments as a license to disregard the intent of Congress.

3. The Post 1970 Interpretation of the Statute.

A. Introductory

The cases relied on by the court below all of which were decided after the 1970 amendments, which granted exclusive jurisdiction on dischargeability to the bankruptcy courts, have assumed that that grant wiped the slate clean as to the body of substantive law which had been created in the state courts, particularly following the adoption of the Celler Amendment. See e.g. *In Re Schuerman,* 367 F. Supp. 1347 (E. D. Ky. 1973) and *In Re Ellis,* 400 F. Supp. 1112

(S. D. N. Y. 1975) one of the bulwarks of the decision below. Nothing in § 17(a)(2) or in the legislative history can support this extraordinary position.

The 1970 amendments cannot be considered to have preempted bankruptcy law for the bankruptcy courts. The state courts whose rulings have been ignored were interpreting Federal law. And they were doing so in reliance on the intent of Congress as reflected in the Celler Amendment. A typical decision showing this is *HFC* v. *Walters,* 433 P 2d 929, decided in 1968 by the Court of Appeals of Arizona. The Court said on the point here involved:

> "Both the plain terms of the changes effected by the Celler Amendment and its legislative history indicate a give-and-take whereby the lenders gave up their power to oppose a discharge under Section 14 of the Act and took in return express Congressional adoption of the hitherto supposed "majority rule" that an extension or renewal of existing indebtedness in reliance upon a materially false written financial statement is not dischargeable and that the entire indebtedness may be recovered by the lender after the borrower's discharge in bankruptcy.
>
> Cases involving renewal or extension loans decided under Section 17(a)(2) as altered by the Celler Amendment have uniformly given effect to its new provisions and have held that the lender may recover the renewed prior indebtedness as well as the new money advanced at the time of the making of the false financial statement. A number of these decisions have come from jurisdictions which previously took the view that the lender could recover only the new money advanced. The Bankruptcy Act is the paramount law of the land under our Federal Constitution, Article I, Section 8, and see

> 1 Collier, Bankruptcy, Section 0.02, and 4, and it is now too late for a contention in Arizona, or elsewhere, that a lender may not recover after bankruptcy indebtedness extended or renewed by the lender on the basis of a false financial statement."

If Congress intended that the bankruptcy courts were to write on a clean slate it surely would have made that plain. The inescapable fact is that Congress was aware of the state decisions as the above-quoted dialogue between Mr. Chapman and Senator Ervin shows and manifested nothing to indicate dissatisfaction with the courts' interpretation of § 17(a)(2). See for agreement on this point, the views of Professor Philip Shuchman, a prominent consumer advocate, as expressed in *The Fraud Exception in Consumer Bankruptcy,* 23 Stanford Law Review 735, 766 (1971) and in *Impact Analysis of the 1970 Bankruptcy Discharge Amendments,* 61 North Carolina Law Review 233, 239 (1972). There is therefore no basis whatsoever for the following statement by Judge Carter in *In Re Ellis, supra:*

> "The 1970 amendments to the Bankruptcy Act granted the federal courts exclusive authority to ascertain the dischargeability of debts and this obviates the need to either choose, reconcile or refer to state law in this area. See 11 U. S. C. § 35(c)."

The error consists in the reference to state law rather than to a recognition that the state courts had reached a unanimous view regarding federal law.

Nor was Judge Carter on sounder grounds when he said the following:

> "The exercise of this jurisdiction [conferred by the 1970 amendments] is dedicated not to acquiescence

> with conflicting local rules but to the creation and maintenance of uniform federal standards consistent with the equitable framework of proceedings in bankruptcy. *In Re Schuerman, supra,* 367 F. Supp. at 1349.
>
> Unfortunately the federal courts have not fared much better than the state courts in their attempt to achieve uniformity. Courts in this circuit also have gone their separate ways when this issue has been addressed. *Compare Matter of Shade* (W. D. N. Y. July 24, 1974) with *In Re Soika, supra.*" (bracketed matter supplied).

The state courts had reached uniformity on the fresh cash issue as we have noted above and see *Shuchman, supra* in 23 Stanford Law Review, fn. 25 at pp. 740-741. The federal courts, however, as Judge Carter acknowledged, are divided.

As we show below the adverse federal decisions on the fresh cash issue reflect a bias in favor of the dishonest debtor on the part of bankruptcy judges which Congress never intended and which the federal judges mistakenly adopted.

The bias of the bankruptcy judges is reflected in HR 32 which died with the expiration of the last Congress. Drafted and filed by the National Conference of Bankruptcy Judges it would have barred discharge under § 17(a)(2) only as to fresh cash. It is interesting, however, to note that HR 6 which has been introduced in the present Congress rewrites § 17(a)(2) as § 523 but makes no substantive change.

We now turn to an analysis of the statute and the fallacious reasoning of the cases relied on by the court below.

B. The Federal Cases.

As we have shown, the statute in light of its development, legislative history and plain language requires rejection of the fresh cash doctrine.

This was recognized by Judge Burke in an unreported decision in *Matter of Shade* (W.D.N.Y. 1974) (annexed hereto for the Court's convenience). He held in a case on all fours with that at bar that § 17(a)(2) plainly made the new indebtedness non-dischargeable. He wrote in pertinent part:

> "The 1960 amendment inserted in Clause 2 the prohibition against discharge in bankruptcy from debts which are liabilities for obtaining money or property on credit or obtaining an extension or a renewal of credit by furnishing false financial statements. The unequivocal language of Section 17a(2) of the Bankruptcy Act (11 U.S.C. Section 35a2) added by the 1960 amendment, requires a holding that the full amount of the indebtedness, including both the amount of the note representing an extension of the pre-existing indebtedness and that part of the note representing new money advanced, be held non-dischargeable."

The cases espousing the fresh cash theory on the other hand have employed a number of specious devices to thwart the Congressional intent.

Emphasis has been placed on the fresh start for a bankrupt concept. Ignored has been the principle that a discharge is a privilege to be extended only to an honest debtor. See 1 A Collier *on Bankruptcy* (14th ed.) p. 1261 and the cases there collected. Collier writes:

> "The primary purpose of bankruptcy statutes is the collection and distribution of the debtor's estate to his

> creditors. The discharge of the bankrupt is a secondary purpose designed to give the honest debtor the opportunity to reinstate himself in the business world; *it is not intended to be available to a dishonest debtor.* (Emphasis supplied; footnotes omitted).

In this case, apart from any other consideration, Danns who falsified his financial statement and perjured himself at trial, would hardly seem deserving of any court's consideration.

Another device to thwart the will of Congress had its origin in an unreported decision in *In Re Birkholz,* 71 - BK - 517 (W. D. Wisc. 1972) (annexed hereto for the Court's convenience). There the court, despite the fact that the bankrupt had sought and received a new loan, held that because the new loan was consolidated with the old loan "solely at" the creditor's "instance and for its convenience", the bankrupt had not 'obtained an extension of credit' within the meaning of § 17(a)(2) and that therefore only the 'fresh cash' loaned was not dischargeable."

This erroneous view was thereafter adopted in *In Re Schuerman, supra,* 367 F. Supp. 1347 (E. D. Ky. 1973) and by Judge Carter in *In Re Ellis, supra,* among other decisions to the same effect.*

The correct approach to the small loan act which, as Judge Carter noted in *Ellis* has been enacted in almost all the states, is found in an unreported decision in *HFC* v. *Clem,* B 75-397, 8 (D. C. Ore. 1976) (annexed hereto for the Court's convenience). There Judge Skopil said in pertinent part:

> "The most significant issue raised on this appeal is a legal question: must the renewal of a loan be made

*The Supreme Court of Wisconsin, the state in which *Birkholz* was decided, as well as the other state courts, cited in the footnote at p. 18 *supra,* had no difficulty with the small loan act as appears from *First Credit Corp.* v. *Wellnitz* (Wisc. 1963) 123 N.W. 2d 519.

> for the borrower's convenience in order for the debt to be non-dischargeable under Section 17(a)(2)? In other words, is the creditor limited to a judgment for new money advanced when the renewal is made for the creditor's convenience? This issue is not without its difficulties. But the issue need not be reached if the renewal loan was made for the convenience of defendant borrowers.
>
> The Bankruptcy Judge held that the renewal was for plaintiff's convenience. This finding clearly is not supported by the evidence. Defendants took the initiative in contracting HFC to obtain a new loan. The old and new loans were consolidated because plaintiff believed it was legally obliged to do so for defendant's protection. Even assuming that a creditor making a renewal loan for his own convenience is limited to a judgment for new money advanced, plaintiff does not fall within this class and is entitled to a finding that the entire debt is nondischargeable."

The foregoing view is especially applicable in the case at bar where the record shows that Danns, like Clem, sought the refinancing (A 30). He therefore "obtained" it whether one loan or more than one loan was involved.

In following the statutory scheme, HFC was required to satisfy and return to Danns his old note and as has been shown, Danns executed the new note in suit. It is playing with words to say that Danns did not obtain refinancing of his old debt.

In any event, it is unsound to regard the small loan statute as being inimical to the interests of a borrower. Its intent is obviously to benefit the borrower insofar as

interest charges are concerned and to restrict the lender's method of operation.

Every transaction where a borrower has an outstanding loan is subject to this legislative mandate. Thus in each instance where there is a prior indebtedness, the transaction must become a renewal or extension of credit. Indeed, even if *argvendo,* the consolidation is for the convenience of the creditor, nothing in § 17(a)(2) makes that circumstance an exception to non-dischargeability.

As a related point, the court below held that "HFC did not show that Danns was delinquent in his payments on the prior loan and received an 'extension' of time to pay it off or that he had been granted a renewal of a matured note." (A 83).

Again this is playing with words because the statute bars a discharge as to a debt incurred by "obtaining money or property on credit" as well as where an extension or renewal of credit is obtained. Surely these all-inclusive words reflect an intent to bar a discharge in any situation where credit is obtained. And the note Danns executed on January 24, 1975 represents the credit he obtained.

In any event, the new note did represent an extension of credit because it necessarily involved different monthly payments, a new and extended maturity date (36 months hence) and a moratorium in making the next payment since the first payment on the new note was not due until thirty days after its execution (Ex. 1 at A 75).

Another unsound device to evade the statutory command is the pecuniary loss theory, which was stressed in *In Re Fuhrman,* 385 F. Supp. 1185 (W. D. N. Y. 1973) and was carried forward in *In Re Soika,* 365 F. Supp. 555

(W.D.N.Y. 1973) a case relied on by the court below.* These cases held that the dishonest debtor should only be responsible for the harm done. In other words these courts applied a tort theory notwithstanding that the lender, as here, sues on contract on the new note. This theory, however, is not in accordance with the law as it is and as Congress intended it to be. See *Walters, supra,* 443 P. 2d at 933, where the court refused to apply Arizona's fraud tort law:

> "*** appellee argues that the Arizona law of fraud permits recovery only for "consequent and proximate injury", and that such rule restricts recovery to the amount of the new money advanced. Appellant, however, brought suit in contract on its note, for an undischarged debt, rather than an action in tort for fraud. This it had a right to do. See Seaboard Finance Company v. Barnes, 378 Mich. 627, 448 N. W. 2d 756 (1967), and National Finance Company of Utah v. Valdez, 11 Utah 2d 339, 359 P. 2d 9 (1961). Nor could Arizona law be applied in any manner which would be inconsistent with or limit the plain meaning and intent of the national Bankruptcy Act. See In re Chicago Rapid Transit Co., 129 F. 2d 1 (7th Cir. 1942), and cases cited therein.
>
> We do not think that this integrated transaction can be severed or disintegrated as a matter of fact or as a matter of law."

§ 17(a)(2) has never been, nor is it now, a remedial statute. The intent is not to remedy wrongs committed by a dishonest bankrupt. The statute clearly sets forth a

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**Soika* misconstrued the legislative history when it confused the meaning of the Celler Amendment. Though a false financial statement was no longer ground for barring a complete discharge it was intended to be ground, as we have shown, for barring a discharge of the debt fraudulently incurred.

standard for dischargeability of a debt. It does not create a cause of action. If under the statute the debtor proves unworthy, the discharge is denied. If the debtor's conduct falls within the area of prohibited activity, it must follow that the debt represented by the new note is non-dischargeable.

Accordingly, it is clear from the above that the judges who have adopted the pecuniary loss theory have disregarded the plain intent of the statute and have engaged in judicial legislation.

Apart from the foregoing, equity favors the appellant here. Danns obtained two valuable considerations through his fraudulent conduct: the new cash advanced and the extension of his prior loan, neither of which he would have received if he had made a truthful disclosure. Thus, if appellant had been given an honest financial statement, it would have been clear that Danns was hopelessly in debt. He was obviously not a suitable candidate for a $2500 loan. It is reasonable to assume that instead of granting Danns a new loan, every effort would have been made to have Danns pay off his existing loan. Those payments which were due would have been pressed and had Danns defaulted for any period, one can be sure that appellant would have immediately accelerated the entire debt. It is therefore clear that equity requires barring a discharge as to the entire debt rather than merely the new money.

SUMMARY

In the final analysis the court below and the courts on whose decisions it relied have ignored the statutory command and have engaged in judicial legislation in an unworthy cause—aiding the dishonest debtor. In fairness such decisions should not be permitted to stand.

CONCLUSION

For the reasons assigned above the order below should be reversed and appellant should be held entitled to recover the sum of $2189.31 with interest from January 24, 1976.

Respectfully submitted,

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FREDERICK H. BLOCK
HARVEY N. GOLDSTEIN
Of Counsel.

ADDENDUM

AD1

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF NEW YORK

In the Matter
of
DONALD E. SHADE,
Bankrupt.

BENEFICIAL FINANCE CO. OF NEW YORK INC.,
Plaintiff,

—*vs*—

DONALD E. SHADE,
Defendant.

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On September 29, 1972 the bankrupt, who then owed Beneficial $603.21 on a prior loan, applied for a new loan and an extension of the prior loan. The bankrupt submitted an application and financial statement. He listed on the statement the balance of the loan owed to Beneficial of $603.21 and a debt to Lincoln Rochester Bank of $2000.00. He then wrote on the application, "I have no other bills." He also set forth his income. A new note for the $1376.37 payable in thirty-six monthly installments was signed by the bankrupt. The prior loan was paid from the proceeds and the prior note was returned to the bankrupt marked "paid". The bankrupt received $340.84. The application and financial statement were false. The bankrupt failed to disclose other debts. His total debts amounted to $6236.00. If Beneficial had known of the additional debts, it would not have approved the loan.

Beneficial contended that its debt, represented by the new note for $1376.37, was not dischargeable. Beneficial filed an application for the determination of the dischargeability of its total debt represented by the new note under Section 17c of the Bankruptcy Act, 11 U. S. C. 35c. After a hearing on November 8, 1973, the Bankruptcy Judge made findings of fact and conclusions of law dated January 4, 1974. He found that on September 29, 1972 the bankrupt obtained a loan in the sum of $341.84 in new money and an extension of a prior loan based on a prior financial application; that in the financial statement of September 29, 1972 the bankrupt failed to list debts amounting to $3600.00 more than the $2600.00 he listed; that the objecting creditor, Beneficial, relied on such application and would not have made the new loan if it had known of the unlisted debts; that the failure to list debts amounting to approximately $3600.00 required the court to find an intent to defraud by the bankrupt. The Bankruptcy Judge made conclusions of law that the bankrupt's indebtedness in the

sum of $341.84 is exempted from his discharge in bankruptcy; and that judgment should be entered in favor of Beneficial and against the bankrupt in the sum of $341.84 with interest, and ordered and adjudged that the indebtedness to Beneficial is a liability for obtaining money or credit or an extension or renewal of credit in reliance upon a materially false statement in writing respecting the bankrupt's financial condition, made with intent to deceive, and that pursuant to Section 17a(2) of the Bankruptcy Act the debt is not dischargeable, and further ordered and adjudged that the application of Beneficial that the debt owing to it by the bankrupt be held not discharged in this proceeding is granted. He further ordered and adjudged that judgment be granted in favor of Beneficial in the sum of $341.84 with interest, together with costs.

On January 21, 1974 Beneficial filed a notice of appeal to this court from that part of the order of the Bankruptcy Judge entered January 15, 1974, granting judgment to Beneficial for the sum of $341.84 with interest on the ground that such amount is inadequate and contrary to law. Beneficial and the bankrupt have submitted the matter for decision to this court on written briefs.

The 1960 amendment inserted in Clause 2 the prohibition against discharge in bankruptcy from debts which are liabilties for obtaining money or property on credit or obtaining an extension or a renewal of credit by furnishing false financial statements. The unequivocal language of Section 17a(2) of the Bankruptcy Act (11 U. S. C. Section 35a2), added by the 1960 amendment, requires a holding that the full amount of the indebtedness, including both the amount of the note representing an extension of the pre-existing indebtedness and that part of the note representing new money advanced, be held non-dischargeable.

The order and judgment of the Bankruptcy Judge, in

so far as it granted judgment in favor of Beneficial in the sum of $341.84 with interest and costs, is reversed upon the ground that the amount of the judgment is inadequate because it represents only that part of the indebtedness of the bankrupt for new money advanced and does not include that part of the indebtedness for the extension of credit for the unpaid balance of the prior note, included in the renewal note.

Beneficial Finance Co. of New York Inc. is entitled to judgment against Donald E. Shade for $1099.89 with interest from November 8, 1973. No costs.

Submit proposed judgment on notice.

s/ HAROLD P. BURKE
Harold P. Burke
United States District Judge

July 24, 1974.

AD5

IN THE

UNITED STATES DISTRICT COURT

FOR THE WESTERN DISTRICT OF WISCONSIN

In the Matter of ALVIN LEONARD BIRKHOLZ, *Bankrupt.*	71-BK-517

ORDER

This is a petition for review of an order entered in the above-entitled action by the referee in bankruptcy on November 4, 1971. Petitioner, Thorp Finance Corporation of Wisconsin, challenges the referee's determination that of a sum of $1625 owed to petitioner by the bankrupt, only $720.47 is not dischargeable under Section 17(a)(2) of the Bankruptcy Act,[1] 11 U.S.C. § 35(a)(2).

In his order, the referee found that prior to September 21, 1970, the bankrupt had obtained several loans from Thorp, on all of which he was current in his payments and for none of which had he submitted a materially false financial statement; that on September 21, 1970, the bankrupt sought a loan of $720.47 in "fresh cash" from Thorp; that on his application for that loan, the bankrupt intentionally omitted to list several creditors to whom he owed substan-

[1]Section 17(a)(2) excepts from discharge in bankruptcy provable debts which

> "are liabilities for obtaining money or property by false pretenses or false representations, or for obtaining money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made . . . with intent to deceive . . . ,"

tial amounts; that Thorp agreed to the loan of the $720.47; that "solely at [its] instance and for its convenience," Thorp incorporated the "fresh cash" and the refinanced balance of the bankrupt's previous loans into one obligation; and that the bankrupt did not seek to have the old balance refinanced. The referee concluded that with respect to the outstanding balance of the previous loans, the bankrupt had not "obtained an extension of credit" within the meaning of Section 17(a)(2) and that therefore only the "fresh cash" loaned was non-dischargeable.

Petitioner concedes that in order for the entire $1625.00 to fall within the exception to dischargeable debts, the bankrupt must have "obtained" the refinancing of his previous loans. It contends, however, that with regard to the question of whether the bankrupt obtained the refinancing, the findings of the referee are clearly erroneous; that the hearing that resulted in the order of November 4 did not focus on that question; and that further factual inquiry would show that the refinancing had been effected for the benefit of the bankrupt and at his instance. In the alternative, petitioner argues that even if the referee's findings of fact are not clearly erroneous, the referee erred as a matter of law in failing to conclude that since the bankrupt had ratified the loan contract, he had "obtained" the refinancing within the meaning of the Act.

On a petition for review, the district court is obliged to accept the referee's findings of fact, unless those findings are "clearly erroneous". *In re Northern Illinois Development Corp.*, 324 F. 2d 104, 106 (7th Cir.), *cert. den., Sportservice Corp.* v. *Northern Illinois Development Corp.*, 376 U. S. 938 (1963); *In re Rafdo Enterprises*, 297 F. 2d 505, 507 (7th Cir. 1961). If the record presented to the reviewing court fails to demonstrate that the referee's findings are in error, it is the burden of the party attacking those findings to show that they are clearly erroneous.

In the case at bar, petitioner has failed to meet that burden. It has asserted that the referee's findings are clearly in error but has offered nothing in support of its assertion. Consequently, on the present state of the record, it cannot be said that the referee's findings of fact are clearly erroneous.

Petitioner's alternative argument is also unpersuasive. For purposes of construing section 17(a)(2) of the Bankruptcy Act, the sole relevant inquiry at bar is whether an extension of credit was "obtained" by the bankrupt; it is not inconceivable that one could ratify a contract which he had not "obtained" within the meaning of the Act. Therefore, even if it is assumed that the bankrupt did ratify the loan contract, it does not follow that he "obtained" that contract. Hence, the referee did not err in failing to conclude that the bankrupt's ratification of the loan constituted an "obtaining" of an extension of credit; and his order may not be reversed on that ground.

Accordingly, for the reasons stated above, IT IS HEREBY ORDERED that the petition for review of Thorp Finance Corporation is dismissed.

Entered this 11th day of February, 1972.

BY THE COURT:

s/ JAMES E. DOYLE
James E. Doyle
District Judge

AD8

IN THE

UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF OREGON

HOUSEHOLD FINANCE CORPORATION *Plaintiff,* *v.* ROBERT D. CLEM and MYLET J. CLEM, *Defendants.*	No. B75-397 B75-398

OPINION

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SKOPIL, Judge:

Defendants, Robert D. Clem and Mylet J. Clem, husband and wife, filed bankruptcy in the U. S. District Court for the District of Oregon. Plaintiff, Household Finance Corporation of Salem (HFC), a creditor of defendants, sought a determination that their debt was nondischargeable. Plaintiff appeals from the decision of the Bankruptcy Judge granting judgment for only a portion of the amount

claimed to be owing. I reverse as to the amount of the judgment granted.

On March 27, 1974, defendants obtained a loan from plaintiff in the sum of $1,135.58, promissing to repay the loan according to the terms of a promissory note which they executed (Ex. A to plaintiff's complaint). The sum of $745.44 (the "renewal loan") was applied to the balance of an existing loan from HFC to defendants, and the old note was cancelled. The remaining $390.14 of the loan proceeds (the "new money") was paid to defendants.

Prior to obtaning the loan, defendants furnished to plaintiff a financial statement listing their debts and liabilities (Ex. B to plaintiff's complaint). The statement indicated total debts of $8,341.89, including the balance on HFC's original loan. In fact, however, defendants had additional obligations in the amount of $6,685.13 which they failed to disclose. Defendants knew the financial statement to be false and furnished it with the intent to deceive plaintiff, who relied upon it in entering into the transaction.

After defendants filed for bankruptcy, plaintiff sought a determination that their debt was nondischargeable pursuant to § 17(a)(2) of the Bankruptcy Act, 11 U. S. C. § 35(a)(2), which provides:

> "A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as . . . (2) are liabilities for obtaining . . . money or property on credit or obtaining an extension or renewal of credit in reliance upon a materially false statement in writing respecting his financial condition made or published or caused to be made or published in any manner whatsoever with intent to deceive . . . ."

Plaintiff requested a judgment against defendants in the amount of the remaining principal balance of $971.11, together with interest at the rates provided in the note.

Defendants did not file an answer to plaintiff's complaint. Although their attorney appeared at the hearing conducted before the Bankruptcy Judge on May 27, 1975, he presented no evidence on their behalf and stipulated that "[i]f the Court wishes to, the judgment may be entered for the relief sought in the Complaint that has been filed" (Tr. 2-3).

The Bankruptcy Judge, however, expressed concern about the appropriate measure of damages. After brief oral argument and testimony, he ruled that although defendants' debt was not dischargeable, plaintiff was entitled to judgment only in the amount of the new money advanced (*i.e.*, $390.14), plus interest. He reasoned that plaintiff had failed to allege any fraud in connection with the original loan, making that debt nondischargeable. Further, plaintiff was not entitled to damages for the renewal loan of $745.44 because the renewal, having been made solely for plaintiff's convenience, should not result in a windfall for plaintiff.

On appeal, plaintiff claims error in three respects. First, plaintiff claims that the Bankruptcy Judge was required, because of the stipulation of defendants' attorney, to enter judgment for plaintiff in the sum prayed for in the complaint. This claim is without merit. Defendants' attorney indicated only that judgment could be entered for the relief sought *if the court wished.* Moreover, Bankruptcy Rule 755(a), relied upon by plaintiff, does not preclude an inquiry into the appropriate measure of damages. That rule provides:

> "When a judgment is sought against a party in adversary proceedings and such party has, without sufficient excuse, (1) failed to plead or otherwise defend . . ., the court upon request therefor shall enter a judgment by default, except as provided hereinafter. *If, in order to enable the court to enter*

judgment or to carry it into effect, *it is necessary . . . to determine the amount of damages . . . or to make an investigation of any other matter, the court may conduct such hearings as it deems necessary and proper.*" (emphasis added)

The second error claimed is the holding that plaintiff could not recover the amount of the renewal loan based on fraud pertaining to the original loan because plaintiff had failed to allege such fraud in its complaint. This claim of error is likewise without merit. Plaintiff is not entitled to a judgment merely because fraud has in fact occurred. Under the Bankruptcy Rules, a complaint must contain a statement of each claim showing that the plaintiff is entitled to relief, and the circumstances constituting fraud must be stated with particularity.[1] Plaintiff failed to comply with these rules or to attempt to cure this defect by requesting a continuance or leave to file an amended complaint during the hearing before the Bankruptcy Judge. Under these circumstances, his refusal to consider this new theory was justified.

The most significant issue raised on this appeal is a legal question: must the renewal of a loan be made for the borrower's convenience in order for the debt to be nondischargeable under Section 17(a)(2)? In other words, is the creditor limited to a judgment for new money advanced when the renewal is made for the creditor's convenience? This issue is not without its difficulties. But the issue need not be reached if the renewal loan was made for the convenience of defendant borrowers.

The Bankruptcy Judge held that the renewal was for plaintiff's convenience. This finding clearly is not supported by the evidence. Defendants took the initiative in

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[1]Bankruptcy Rules 708 and 709 incorporate into such proceedings the provisions of Fed. R. Civ. P. 8 and 9.

contacting HFC to obtain a new loan. The old and new loans were consolidated because plaintiff believed it was legally obliged to do so for defendants' protection. Even assuming that a creditor making a renewal loan for his own convenience is limited to a judgment for new money advanced, plaintiff does not fall within this class and is entitled to a finding that the entire debt is nondischargeable.

The judgment below is reversed insofar as it limits the amount of the judgment to the new money advanced. The Clerk is directed to enter judgment for the plaintiff in the amount prayed for in the complaint.

Dated this 24th day of February, 1976.

/s/ Otto R. Skopil
United States District Judge